

ANALYSIS OF ORIGINAL BILL

Author: Kelley Analyst: Marion Mann DeJong Bill Number: SB 1871

Related Bills: See Legislative History Telephone: (916) 845-6979 Introduced Date: 02/19/98

Attorney: Doug Bramhall Sponsor: U.S. Borax, Inc.

SUBJECT: Business Income Apportionment/Extractive Activity/25% of Gross receipts
Within California

SUMMARY

This bill would modify the definition of "extractive business activity" for purposes of applying the three-factor apportionment formula to include only those extractive businesses where at least 25% of its extractive receipts are generated in California.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately and would apply to income years beginning on or after January 1, 1998.

LEGISLATIVE HISTORY

SB 1176 (Stats. 1993, Ch. 946), SB 1880 (Stats. 1994, Ch. 861), SB 715 (Stats. 1996, Ch. 952).

SPECIFIC FINDINGS

Article III, Section 3.5 of the California Constitution provides that an administrative agency does not have the power to declare a statute unenforceable, or refuse to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute, unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

Under current California law, California income for corporations which operate both within and without the state is determined using the unitary method of taxation. Under the worldwide unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of the income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales.

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___X___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director Date
Gerald H. Goldberg 3/12/98

Agency Secretary Date

By: Date

California law also allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources.

For most corporations, the apportionment formula used to assign business income to California for tax purposes is the average of property, payroll and sales (used twice in the formula). The factors are then divided by four. Each factor is the ratio of in-state activity to that same activity everywhere. This formula is known as "double-weighting" because the sales factor is repeated twice and the calculation is:

$$\frac{\frac{(\text{CA Sales})}{(\text{All Sales})} + \frac{(\text{CA Sales})}{(\text{All Sales})} + \frac{(\text{CA property})}{(\text{All property})} + \frac{(\text{CA payroll})}{(\text{All payroll})}}{4} = \text{California apportionment percentage}$$

Total business income is multiplied by the apportionment percentage to determine the appropriate income assigned to the taxing jurisdiction.

For savings and loans, banks and financial corporations and corporations in agricultural or extractive industries, this formula is the simple average of the three factors, known as "single-weighting."

The existing state law specifies that if a unitary business is engaged in both a qualified activity (agriculture, extractive, savings and loan, banking or financial activity) and a general business activity, a "gross business receipts" test shall be used to determine if the unitary business shall use the single- or double-weighting formula. If one or more corporations are required to file a combined report, the entire combined business of the group is subject to the more than 50% gross business receipts test and the entire business income of the unitary group is apportioned using either single- or double-weighting.

This bill would create a "pre-test" for purposes of applying the three-factor apportionment formula by modifying the definition of "extractive business activity" to include only those extractive businesses where at least 25% of the gross receipts associated with activities relating to the production, refining, or processing of oil, natural gas, or mineral ore are generated in California. Thus, the ratio of California extractive receipts over total extractive receipts must equal or exceed 25%.

A corporation that meets the 25% pre-test would then classify all of its receipts from extractive activity worldwide as a "qualified business activity" which would then be aggregated with its other "qualified business activity" receipts (i.e., agricultural, savings and loan, and banking or financial receipts, if any) and be subjected to the 50% test for determining if the three-factor apportionment formula applies. Businesses that do not meet the 25% pre-test would not be treated as engaged in a qualified business activity with respect to their extractive activity and would therefore automatically fall into the requirement for double-weighting the sales factor (though such business might still be treated as engaged in a qualified business activity with respect to its other business activities, such as agricultural activities).

Policy Considerations

Because most large oil and gas companies have international or at least U.S.-wide sales activity, only a few companies principally based in California would be subject to the single-weighting formula.

Legal Considerations

The provisions of this bill are susceptible to constitutional challenge, as discriminatory under the commerce clause. Challenges could come from either an entity forced to remain in the single-weighting formula or forced into the double-weighting formula. Although the current law provision makes distinctions between classes of taxpayers, it does not facially make such distinctions based upon geographic activity within the state.

Implementation Considerations

Implementation of the provision of this bill would occur during the department's normal annual system update.

Technical Considerations

The effect of the phrase "(except as otherwise provided in paragraph (3) of subdivision (d))" on page 2, lines 10 and 11 of the bill is unclear. The 25% limitation provided in paragraph (3) of subdivision (d) controls the definition of an "extractive business activity," it does not impact the 50% "gross business receipts" test in subdivision (b). Amendment 1 would delete the phrase.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

It is estimated that this bill would increase tax liability for some taxpayers and reduce tax liability for others, resulting in an overall net impact to B&CT revenues as shown in the following table.

Estimated Revenue Loss of SB 1871 Income Years Beginning on and After January 1, 1998 Enactment Assumed After June 30, 1998 \$ Millions		
1998-99	1999-00	2000-01
(\$2)	(\$1)	(\$1)

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

This estimate was developed using the 1995 B&CT sample data for oil and gas extraction companies. It was assumed that corporations with sales factors less than 25% would be required to use a four-factor apportionment formula. The average apportionment factors for these corporations were calculated using double-weighting formula. The tax revenue impact was estimated using the calculated average apportionment factors compared with the single-weighting formula. The estimates were grown using an annual 5% inflation assumption.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1871
As Introduced February 19, 1998

AMENDMENT 1

On page 2, modify lines 10 and 11 as follows:

than 50 percent ~~(except as otherwise provided in paragraph (3) of subdivision~~
~~(d))~~ of its "gross business